

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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PLR-133377-07

Date:

August 22, 2007

### LEGEND:

Distributing =

New Distributing =

Controlled =

Business 1 =

Business 2 =

Asset 1A =

Activity 1B =

Asset 2 =

Estate =

PLR-133377-07

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Shareholder F =

Shareholder G =

Date 1 =

Date 2 =

Day 3 =

Date 4 =

Year 5 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

i =

k =

Dear :

This letter responds to your July 11, 2007 letter requesting rulings on certain federal income tax consequences of a proposed transaction. The information provided in that letter and in later correspondence is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process. In particular, this office has not reviewed any information pertaining to, and has made no determination regarding, whether the Distribution (described below): (i) satisfies the business purpose requirement of §1.355-2(b) of the Income Tax Regulations, (ii) is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both (see § 355(a)(1)(B) of the Internal Revenue Code and §1.355-2(d)), or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in Distributing or Controlled (see § 355(e) and §1.355-7).

### SUMMARY OF FACTS

Distributing is a closely held corporation that was incorporated on Date 1 by Shareholder A and his wife and two of their sons, Shareholder B and Shareholder C. A third son, Shareholder D, later became a Distributing shareholder by way of gifts from Shareholder A. Shareholder A passed away on Date 2.

Distributing is a cash method taxpayer that files its returns using a year ending Day 3. On Date 4, Distributing converted from a subchapter C corporation to a subchapter S corporation.

Distributing has a shares of common stock outstanding, which are held as follows: Estate owns b shares, Shareholder B owns c shares, Shareholder C owns c

shares, Shareholder D owns d shares, Shareholder E (Shareholder B's wife) owns e shares, and Shareholder F (Shareholder C's wife) owns e shares. Prior to the Distribution, the shares of Distributing stock owned by the Estate will be distributed as follows: f shares to Shareholder B, f shares to Shareholder C, and d shares to Shareholder G (the adult son of Shareholder B and Shareholder E).

Distributing has directly conducted Business 1 and Business 2 since its incorporation on Date 1. In Year 5, Distributing disposed of Asset 1A and began to expand Activity 1B. Distributing has submitted financial information indicating that Business 1 and Business 2 each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

During his lifetime, Shareholder A loaned money in the amount of \$g to Distributing. That loan was callable upon demand during Shareholder A's lifetime. The loan is now represented by a note (the "Note"), which is held by the Estate. The Note is payable over h years and will be distributed equally to Shareholder B, Shareholder C, and Shareholder D prior to the Distribution.

Shareholder B and his family have been principally involved with Business 1 while Shareholder C and his family have been principally involved with Business 2. Significant personal conflict exists between those two families regarding the operation of Business 1 and Business 2. To resolve management, systemic, and other problems that have arisen because of irreconcilable differences between the Distributing shareholders, Distributing has proposed to separate Business 1 and Business 2 into two separate corporations with the family of Shareholder B owning one corporation and the family of Shareholder C (including Shareholder D) owning the other corporation.

### **PROPOSED TRANSACTION**

For what are represented to be valid business reasons, Distributing has proposed the following transaction (the "Proposed Transaction"):

- (i) Distributing will transfer the assets comprising Business 2 to newly formed Controlled in exchange for j shares of Controlled's only class of stock and Controlled's assumption of the liabilities related to Business 2, including j percent of the Note (the "Contribution").
- (ii) Immediately following the Contribution, Distributing will distribute all of its Controlled stock as follows: (a) k shares of Controlled stock to Shareholder C, (b) d shares of Controlled stock to Shareholder D, and (c) e shares of Controlled stock to Shareholder F, in each case, in exchange for all of the respective shareholder's shares of Distributing stock (the "Distribution").

Following the Distribution, Distributing will lease Asset 2 from Controlled at fair market value while Distributing looks for replacement property for use in Business 1.

Effective upon the Distribution, Distributing will change its name to New Distributing.

## **REPRESENTATIONS**

Distributing makes the following representations regarding the Contribution and the Distribution:

- (a) The fair market value of the Controlled stock and other consideration to be received by each Distributing shareholder will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation (except for the disposal of Asset 1A and the expansion of Activity 1B), and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements submitted (except for the expansion of Activity 1B).
- (d) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (e) The Distribution is carried out for the following corporate business purposes: (i) to enable Shareholder B and his family to focus on Business 1 and to enable Shareholder C and his family, together with Shareholder D, to focus on Business 2; and (ii) to eliminate deadlock in the making of decisions by Distributing's officers regarding key matters such as business expansion, financing, compensation and employee benefits, hiring, and allocation of management and operational responsibilities among Distributing's officers and employees. The Distribution is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (f) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (g) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or

more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

- (h) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.
- (i) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing equals or exceeds the sum of the liabilities assumed (as determined under § 357(d)) by Controlled.
- (j) The liabilities assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.
- (k) The total fair market value of the assets transferred by Distributing to Controlled will exceed the sum of (i) the amount of any liabilities assumed (within the meaning of § 357(d)) by Controlled in connection with the exchange, (ii) the amount of any liabilities owed to Controlled by Distributing that are discharged or extinguished in connection with the exchange, and (iii) the amount of cash and the fair market value of any other property (other than stock and securities permitted to be received under § 361(a) without the recognition of gain) received by Distributing in connection with the exchange. The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the exchange.
- (l) To the extent any transfer in the Proposed Transaction is an early disposition of property for which an investment credit has been (or will be) claimed under § 46, the income tax liability for the taxable year in which the investment credit property (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or § 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect the early disposition of the property.

- (m) Distributing has neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (n) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.
- (o) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (p) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (q) The Distribution is not part of a plan or series of related transactions (within the meaning of § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).
- (r) Immediately after the Distribution (taking into account § 355(g)(4)), neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of § 355(g)(2)).
- (s) Controlled will make an election under § 1362(a) to be treated as an S corporation (within the meaning of § 1361(a)) on the first available date after the Distribution.
- (t) There is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

## **RULINGS**

Based solely on the information and representations submitted, we rule as follows on the Contribution and the Distribution:

- (1) The Contribution followed by the Distribution will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" under § 368(b).
- (2) Distributing will not recognize any gain or loss on the Contribution (§§ 357(a) and § 361(a)).
- (3) Controlled will not recognize any gain or loss on the Contribution (§ 1032(a)).

- (4) Controlled's basis in each asset received in the Contribution will be the same as the basis of that asset in the hands of Distributing immediately before its transfer (§ 362(b)).
- (5) Controlled's holding period in each asset received from Distributing in the Contribution will include the period during which Distributing held that asset (§ 1223(2)).
- (6) Distributing will not recognize any gain or loss on the Distribution (§ 361(c)).
- (7) Shareholder C, Shareholder D, and Shareholder F will not recognize any gain or loss (and will not otherwise include any amount in income) on the receipt of shares of Controlled stock in the Distribution (§ 355(a)(1)).
- (8) The aggregate basis of the Controlled stock received by Shareholder C, Shareholder D, and Shareholder F in the Distribution will be the same as the shareholder's aggregate basis in the Distributing stock surrendered in the exchange, allocated in the manner described in §1.358-2 (§ 358(a)(1), (b) and (c)).
- (9) The holding period of the Controlled stock in the hands of Shareholder C, Shareholder D, and Shareholder F will include the holding period of the Distributing stock surrendered in exchange therefor, provided the Distributing stock is held as a capital asset on the date of the Distribution (§ 1223(1)).
- (10) Earnings and profits, if any, will be allocated between Distributing and Controlled in accordance with §§ 312(h) and 1.312-10(a).

### **CAVEATS**

We express no opinion about the tax treatment of the Proposed Transaction under other provisions of the Code and regulations or the tax treatment of any condition existing at the time of, or effects resulting from, the Proposed Transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding:

- (i) Whether the Distribution satisfies the business purpose requirement of §1.355-2(b);
- (ii) Whether the Distribution is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled (see §§ 355(a)(1)(B) and 1.355-2(d));
- (iii) Whether the Distribution and an acquisition or acquisitions are part of a plan (or series of related transactions) under § 355(e)(2)(A)(ii); and



- (iv) Whether the Note represents a debt or equity interest.

### **PROCEDURAL STATEMENTS**

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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Richard K. Passales  
Senior Counsel, Branch 4  
Associate Chief Counsel (Corporate)